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Accounting for vested pension benefits existing or arising when a plant is closed or a business segment is discontinued; Issues paper (1980 February 5)

American Institute of Certified Public Accountants. Task Force on Pension Plans and Pension Costs

ISSUES PAPER

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Accounting for Vested Pension Benefits Existing or Arising When a Plant Is Closed or a Business Segment Is Discontinued

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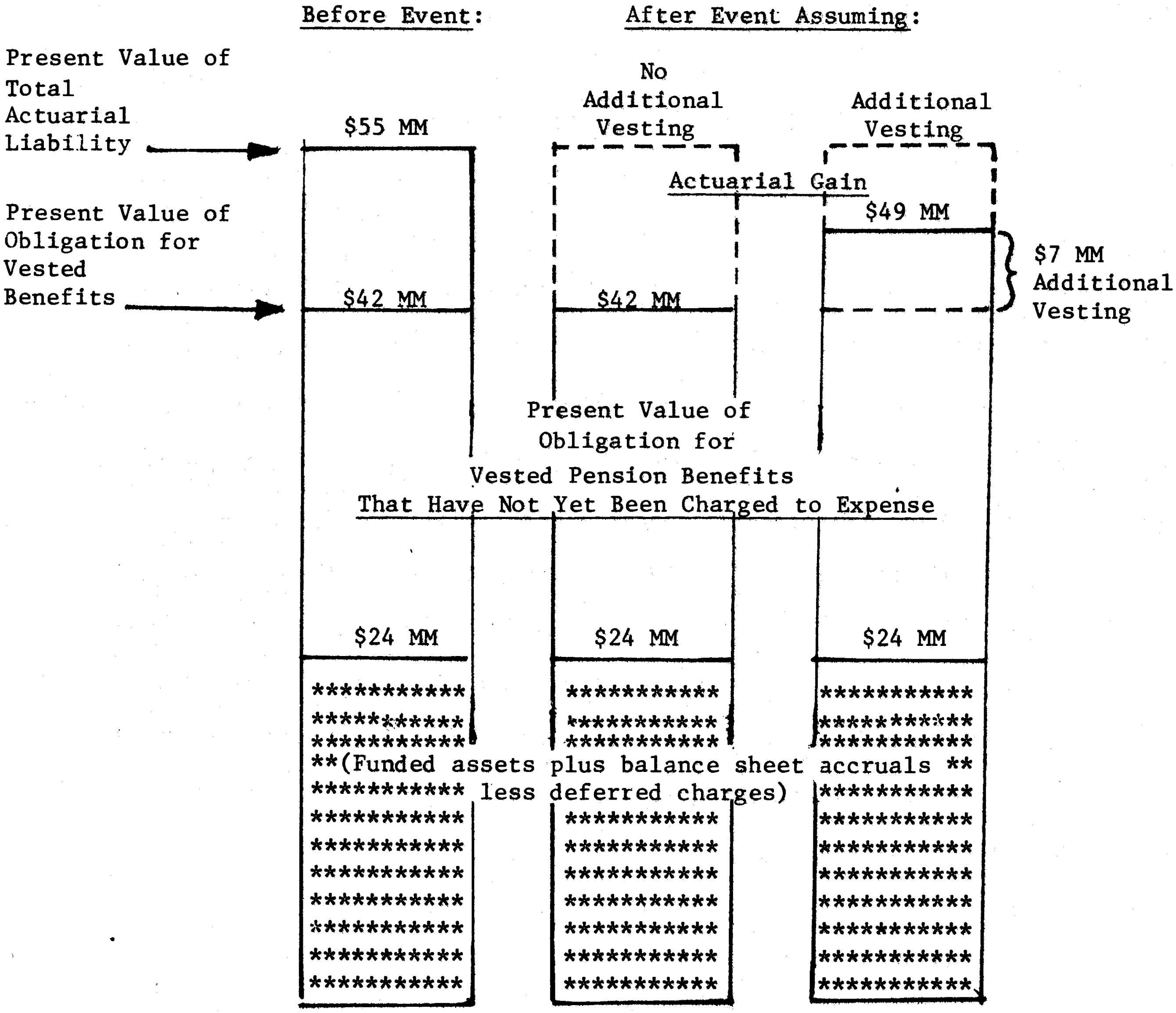
1. This paper addresses issues concerning the accounting for vested pension benefits existing or arising when a plant is closed or a business segment is discontinued. Because accounting literature is not clear on this issue, some diversity in practice has evolved. The issues discussed in this paper may also apply to other events that result in major employee terminations such as significant work force reductions due to technological changes.

2. "Vested pension benefits" are nonforfeitable because they do not depend on future service. Thus, when a plant is closed or a business segment is discontinued, the present value of the obligation for those benefits to terminated employees can be actuarially estimated based on the vesting provisions of the plan, the service rendered by those participants through the date of termination, and certain other actuarial assumptions.

3. This paper does not address accounting for pension obligations arising from the termination of a pension plan. The Employee Retirement Income Security Act (ERISA) specifies the employer's obligation in those circumstances and FASB Interpretation No. 3 specifies the accounting for that obligation.

4. To provide perspective, the following is a simplified illustration of the present value of the obligation status of the sponsor of a defined benefit pension plan to the plan participants of the closed facility before and after the type of event contemplated by this paper, and assuming (a) that the event does not result in additional vesting and (b) that the event creates $7 million of additional vesting:



RELEVANT ACCOUNTING LITERATURE

5. Paragraphs 30 and 31 of APB Opinion 8, "Accounting for Pension Costs," state:

> 30. The Board believes that actuarial gains and losses, including realized investment gains and losses, should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost. Accordingly, except as otherwise indicated in Paragraphs 31 and 33, actuarial gains and losses should be spread over the current year and future years or recognized on the basis of an average as described in Paragraph 26.....
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> 31. Actuarial gains and losses (emphasis added) should be recognized immediately if they arise from a single occurrence not directly related to the operation of the pension plan and not in the ordinary course of the employer's business. An example of such occurrences is a plant closing, in which case the actuarial gain or loss should be treated as an adjustment of the net gain or loss from that occurrence and not as an adjustment of pension cost for the year...

6. As shown by the illustration in paragraph 4, the "actuarial gain" resulting from such an event does not seem to be relevant to the issue of accounting for vested pension benefits. A literal interpretation of Paragraph 31 of APB Opinion 8 would require a credit to income in the period in which the event occurs, with future amortization of the resulting deferred charge. Some have questioned whether that was the intent of APB Opinion 8.

7. Paragraphs 16 and 17 of APB Opinion 30, "Reporting the Results of Operations," state:

> 16. Gain or loss from the disposal of a segment of a business should not include adjustments, costs, and expenses associated with normal business activities that should

> have been recognized on a going-concern basis up to the measurement date, such as adjustments of accruals on long-term contracts or write-down or write-off of receivables, inventories, property, plant, and equipment used in the business, equipment leased to others, deferred research and development costs, or other intangible assets. However, such adjustments, costs, and expenses which (a) are clearly a direct result of the decision to dispose of the segment and (b) are clearly not the adjustments of carrying amounts or costs, or expenses that should have been recognized on a going-concern basis prior to the measurement date should be included in determining the gain or loss on disposal. Results of operations before the measurement date should not be included in the gain or loss on disposal...
>
> 17. Costs and expenses directly associated with the decision to dispose include items such as severance pay, additional pension costs employee relocation expenses, and future rentals on long-term leases to the extent they are not offset by sub-lease rentals (emphasis added).

8. Some believe the term "additional pension costs" in Paragraph 17 of APB Opinion 30 restricts the cost to be recorded to that arising as a direct result of the event ($7 million in the illustration in paragraph 4).

PRESENT PRACTICE

9. It is believed that the predominant practice is to record vested pension benefits existing or arising when a plant is closed or a business segment is discontinued in full as an expense at the time of the event, although the division is aware of some cases in which companies have continued to accrue vested pension benefits relating to a closed facility on an actuarial basis within the minimum and maximum requirements of APB Opinion 8.

10. The results of a NAARS search proved inconclusive since there was no way of determining from the financial statements or from their accompanying notes the precise manner in which the companies surveyed accounted for the pension costs described in this paper.

ISSUES

Basic Issue

11. The basic issue is whether the vested pension benefits existing or arising when a plant is closed or a business segment is discontinued that have not yet been charged to expense should be amortized over future periods or charged to expense immediately.

12. Argument for Amortization. Some believe that pension costs relate to all participants in a plan as a whole rather than to any specific employees. Therefore, the vested pension benefits of terminated employees not yet charged to expense should continue to be accrued on an actuarial basis within the minimum and maximum requirements of APB Opinion 8. Accounting for costs relating to employees affected by a plant closing or discontinuance of a business segment differently from the way a company accounts for past service costs of continuing and retired employees is not justified because those types of events are an ordinary part of the operation of a pension plan, as evidenced by including turnover assumptions in the actuarial calculations. Accordingly, the costs should not be immediately recognized as an expense.

13. Others who believe that the costs should be amortized argue that a liability for the present value of the vested pension obligation should be recorded in the balance sheet with a corresponding deferred charge to be amortized over future periods.

14. Argument for Immediate Recognition. Others believe that plant closings and discontinuances of business segments are not events occurring in the ordinary course of business and, thus, the vested pension benefits existing or arising at the time of such events that have not yet been charged to expense should be recognized immediately. Their primary argument is that no future benefits are to be derived from the future pension payments to be made to the former employees of the closed facility.

Collateral Issues

15. If the vested pension benefits existing or arising when a plant closes or a business segment is discontinued should be charged to expense immediately, among the collateral issues that should be addressed are:

1. Should the costs relating to those whose retirement preceded the event be accounted for differently from the costs relating to those terminated or forced into retirement as a result of the event?
2. How should the costs be classified in the income statement?

16. Collateral Issue 1. Of those who believe that the vested pension benefits of terminated employees that have not yet been charged to expense should be recorded at the date of the event, some believe that such accounting should not extend to employees whose retirement preceded the event. They argue that the provisions of APB Opinion 8 permit the accrual of cost beyond the date of retirement and that the event is not relevant to, and should not have any effect on, the accounting for those costs. Others believe the accounting for the liability to both groups should be the same. They argue that since the plant or segment will not be productive in the future, there is no basis to defer any costs related to the closed facility to be charged against the future operations of other units of the business.

17. Collateral Issue 2. Some believe the expense to be recorded should be classified as a cost of the plant closing or, if the event qualifies, as a component of the gain or loss from discontinued operations, since the event accelerated recognizing these costs.

18. Others believe that since the expense represents the cost of prior service, it should be classified as either normal pension expense, in the case of a plant closing, or as a part of the operating results from discontinued operations.

19. Of those who would record the expense as a part of the gain or loss from the event, some would limit this accounting to only the additional cost associated with the event

($7 million in the illustration in paragraph 4). They argue that the $7 million is the only additional cost that can be directly associated with the event.

OTHER MATTER

Allocation of Plan Assets

20. Plan participants at different facilities usually belong to one plan whose assets generally have not previously been apportioned by facility or by various categories of participants (for example, retired and on-going).

21. However, when a plant is closed or a business segment is discontinued and the vested pension benefits relating to the various categories of participants at the closed facility are accounted for at the time of such event, plan assets must be allocated to the closed facility in some rational manner before the amount of pension costs to be recorded for that facility can be determined. However, such an allocation is not an accounting matter. Some of the methods of allocation generally used by actuaries, include:

- o <u>specific identification</u>, which may not be feasible if the plan has covered many participants and many facilities over a long period.
- o <u>a first-in, first-out method</u> in which plan assets are deemed to belong first to retired employees, then to vested employees, and then to nonvested employees.
- o <u>a statistical method</u> in which plan assets are allocated based on the relative vested pension benefits of the participants (and categories of participants)

of the closed facility to the total vested pension benefits of all participants.

22. The division endorses any equitable method of allocation and urges the actuarial profession to develop a uniform and supportable set of standards for allocation in this area.

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ADVISORY CONCLUSIONS

23. The following are the advisory conclusions of the Accounting Standards Executive Committee and its Task Force on Pension Plans and Pension Costs concerning the issues raised in this paper.

Basic Issue

24. When plants are closed or business segments are discontinued resulting in the termination of employees and that was not contemplated in the normal turnover assumption, the present value of vested pension benefits for all terminated employees that have not yet been charged to expense should be recorded in full as an expense at the measurement date. AcSEC (14 yes, 1 no); Task Force (7 yes, 0 no).

Collateral Issue 1

25. Conversely, similar treatment of vested pension benefits applicable to retired employees (whose retirement preceded such events) is inconsistent with the underlying concepts of APB Opinion 8; that cost (as well as the cost associated with active employees not terminated because of these events, for example, transfers to other locations) should be accounted for in the same way as those applicable to

other ongoing and retired plan participants. The FASB should specifically consider the appropriateness of these provisions in its reconsideration of APB Opinion 8. AcSEC (12 yes, 3 no); Task Force (7 yes, 0 no).

<u>Collateral Issue 2</u>

26. The division observes that, as part of its conceptual framework project, the Financial Accounting Standards Board is studying the various ways in which enterprises should report transactions and the results of other events in their financial statements. The FASB calls this "display considerations." The division believes that the FASB should specifically address the display considerations of the costs discussed in this paper.